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Verschuuren, J.M.; Fleurke, F.M.

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EFFECTIVE AUCTIONING OF EUROPEAN UNION EMISSIONS TRADING SCHEME ALLOWANCES IN A GLOBALIZED MARKET FOR CARBON DIOXIDE

VERSCHUUREN, JONATHAN* AND FLEURKE, FLOOR**

* Professor of International and European Environmental Law, Tilburg Law School, Post Office Box 90153, 5000 LE Tilburg, The Netherlands, Email: j.m.verschuuren@tilburguniversity.edu

** Assistant Professor, Tilburg Law School, Post Office Box 90153, 5000 LE Tilburg, The Netherlands, Email: f.m.fleurke@tilburguniversity.edu

1 INTRODUCTION

The European Union Emissions Trading Scheme (EU ETS) is the largest trading program in the world to combat global climate change. However, the effectiveness of the system—scrutinized since its inception in 2005 by both economists and lawyers—is thus far flawed. The crucial importance of a well-developed implemented compliance chain has been neglected. Only after it was discovered that carbon trading fraudsters may have accounted for up to 90% of all market activity in some European countries, with criminals pocketing billions, according to European law enforcement agencies, the compliance issue received increased attention. The EU ETS legislation originally left a considerable amount of discretion to Member States. That decentralized approach pursued in the Directive has adversely affected the effectiveness of the system. Later amendments to the EU legislation on the ETS have gradually reduced the level of decentralization.

The latest changes made to the ETS, the ones that apply to the third trading phase (2013-2020), have greatly centralized the ETS. In particular, Auctioning Regulation 1031/2010 coordinates auctions by establishing common auctioning platforms, sets forth sanctioning responsibilities of auction platforms in cases of suspected criminal or abusive behavior by participants, and endows financial and other competent national authorities with broad investigative and enforcement powers. In this contribution we will focus on how market abuse is prevented under this system, and we will examine what national and interregional regulators should take into consideration when designing and enforcing integrated auctioning systems.

2 PHASE 3: REGULATORY IMPROVEMENTS ON A COMMON AUCTIONING SYSTEM

Building on improvements to monitoring, reporting and verification made in the second phase (2008-2012), the start of phase 3 of trading saw additional changes pertaining to a strict, robust and transparent system deemed essential for compliance and enforcement, including series of reforms in accordance with Auctioning Regulation 1031/2010.

Under the new Auctioning Regulation, a common auctioning infrastructure where a common auction platform conducts the auctions is expected to reinforce the price signal to achieve abatement of emissions at least costs. Such an approach should also avoid market abuses, such as the widely reported strategy of demand reduction, under which firms falling under the EU ETS understate their demand for allowances in order to buy them at lower prices. Auctioning is considered the most transparent allocation method to prevent this and has therefore become the default method of allocating allowances within the EU ETS.

The Auctioning Regulation assigns different tasks regarding enforcement and monitoring to different actors at different levels: auction platforms, an Auction Monitor and several national authorities supervising the financial sectors. The Regulation explicitly grants enforcement powers to both the auction platform and national authorities for the financial markets, which will be highlighted below. For the effective and efficient prevention and detection of market manipulation it is important to understand how crucial information between the various actors is to be exchanged.

2.1 Auction Platforms

Auctions are held by auction platforms appointed by national governments, but each auction is open to buyers from anywhere in the European Union and the European Economic Area-European Free Trade Association. The Auctioning Reg-

ulation provides for the Member States and the European Commission to procure jointly a common platform to auction emission allowances on behalf of the Member States. Member States are entitled to opt out of the common platform and appoint their own auction platform, which Germany, Poland and the United Kingdom have decided to do.

Two auction platforms are already in place. The European Energy Exchange in Leipzig is the common platform for the large majority of countries participating in the EU ETS. The European Energy Exchange also acts separately as Germany's domestic auction platform. The second auction platform is Intercontinental Exchange Futures Europe in London, which acts as the United Kingdom's platform. All Member States are required to submit monthly reports on auctioning for publication on the Commission's website. A single consolidated report is produced on behalf of all Member States participating in the common platform.

The Auctioning Regulation allows, and in some cases requires, that the auction platforms take independent enforcement actions. Article 21 states that persons willfully or repeatedly breaching the Auctioning Regulation have to be sanctioned by the auction platform by refusal, revocation or suspension of admission to bid in auctions. The same sanction must be applied in cases of money laundering, terrorist financing, criminal activity or market abuse, unless the platform is instructed not to apply sanctions by competent national authorities investigating or seeking to apprehend the perpetrators. Furthermore, auctioning platforms are obliged to report suspected money laundering, terrorist financing and other finance-related criminal activity to the financial intelligence unit instituted under the European Union Anti-Money Laundering Directive. Auctioning platforms also have to inform the competent national authorities for the investigation and prosecution of market abuse when such abuse is suspected.

Similar sanctions can be imposed on persons negligently in breach of the Regulation, or persons who otherwise behave in a manner that is prejudicial to the orderly or efficient conduct of an auction. Other sanctioning powers of the auction platform include setting a maximum bid-size and taking any other remedial measures necessary to mitigate an actual or potential discernible risk of market abuse, money laundering, terrorist financing or other criminal activity.

Actions taken by auction platforms are subject to an extra-judicial mechanism, as well as to the right of appeal.

2.2 The Auction Monitor

The Auction Monitor has as its central task to observe the conduct of the auctions. It is informed by the auction platforms about any suspected market abuse and by the measures undertaken. The Auction Monitor also receives information about the auction from the competent national authorities. However, the information is only made available upon request, and it could therefore be argued that information flows between national competent authorities, auction platforms and the Auction Monitor should be automatically linked.

2.3 National Financial Authorities

National financial authorities have the most extensive enforcement powers under the Auctioning Regulation. These competent national authorities are established under Directive 2004/39/EC on financial instruments, Directive 2003/6/EC on insider dealing and market manipulation and Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing and are charged with tasks falling under the scope of these directives. In order to carry out all the different tasks designated under these instruments, Member States should clearly assign specific competences to national authorities. Often Member States have chosen one single national authority to be responsible for the implementation, application and supervision of EU financial legislative instruments.

The national authorities receive relevant information on suspicion of market abuse from the auction platforms, other national authorities, and from bidders. There exists thus a constant flow of information that should make it easier to detect large-scale market manipulation. Supervision and enforcement of the prohibitions set in the Auctioning Regulation have been put first and foremost in the hands of the national authorities for the financial markets, who have powers to:

- access any document in any form whatsoever, and to receive a copy of it;
- demand information from any person;
- carry out on-site inspections;
- require existing telephone and existing data traffic records;
- require the cessation of any practice that is contrary to the provisions adopted in the implementation of the above provisions;

- suspend trading;
- request the freezing and/or sequestration of assets; and
- request temporary prohibition of professional activity.

Member States have the obligation to impose effective, proportionate and dissuasive administrative sanctions against the persons responsible for non-compliance. Criminal proceedings as well as measures under national administrative law may be instituted by Member States, possibly by the same competent national authorities that lead the investigation. Through a revision of the Market Abuse Directive, the investigative and administrative sanctioning powers of regulators will be further reinforced in the near future, for instance by criminalising offenses at the EU level.

3 CONCLUSION

A wide range of revisions in the regulatory system facilitating the EU ETS has been implemented, all aimed at improving the robustness of the system through centralization and through tightening the rules on monitoring and compliance. Despite these revisions, checking compliance still is mainly in the hands of national institutions of the 28 Member States. The effectiveness and reliability of the ETS, therefore, still depends on each of their efforts. A lack of compliance in one or a few Member States may harm the functioning of the ETS in the entire EU. This issue becomes even more pressing when third states are joining the EU ETS. The EU's policy is aimed at a gradual expansion of the ETS, with the final aim of transforming the ETS into a global system. Australia is the first non-EU state that will link its ETS to the EU ETS (apart from the European Free Trade Association countries that already were linked earlier).¹

For phase 3 the legal framework for auctioning EU ETS allowances has been tightened in order to address market abuse in an effective and efficient way. The Auction Regulation endows different actors with enforcement powers. Both the national authorities and the auction platforms can take enforcement measures independently. The exchange of information between these different entities is crucial to ensure that these concurring competences are complementary to each other. This should be done in close cooperation with the Auction Monitor as the central entity of oversight.

4 REFERENCES

¹ This publication is part of the ENTRACTE research project, funded by the European Commission under the EU FP7 programme. In a follow up to this paper, we will research the actual compliance efforts in several EU Member States, to test our proposition that centralization of the EU ETS is only effective when such centralization is carried through to the compliance phase as well. The results of this research will become available in 2014.